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SUBJECT: UKRAINE: IMF LIKELY TO SUPPORT RISKY GOU MOVE TO STABILIZE PUBLIC FINANCES

REF: KYIV 576

Classified By: AMBASSADOR WILLIAM B. TAYLOR, REASONS 1.4 (B) AND (D)

Summary and Comment

¶1. (C) On April 14 Prime Minister Yulia Tymoshenko moved quickly after the Rada again failed to include key IMF-related anti-crisis legislation on the agenda. Within hours of the failed vote, the CabMin passed 19 resolutions that aim to provide the fiscal discipline that the IMF expects in return for disbursing the long-overdue, \$1.87 billion second tranche of the Stand-By Arrangement. The action was clearly prepared long before the Rada vote, and now appears to have had the full support of the IMF, which has indicated that it will accept the resolutions in lieu of laws. The IMF now looks set to disburse the second tranche, and its local rep even indicated that the payment could be made in the form of direct budget support. The IMF is less open to the GOU suggestion to combine the disbursement with the payment of the third, significantly larger tranche that could be disbursed in May. Using resolutions instead of laws is a risky strategy, as both the President and Rada deputies could formally challenge the GOU moves in the courts, but the IMF now takes the view that the GOU had few other options in the current political environment. However fragile and institutionally questionable the resolutions may be, they are the quickest option that the GOU has to meet IMF expectations. End summary and comment.

Tymoshenko Acts Quickly After Yushchenko Fails to Deliver

¶2. (C) On April 14 the Rada again failed to address three laws aimed at implementing key IMF conditionalities. None of the drafts received enough votes to be put on the agenda. The roll call ran largely along the lines of the unsuccessful March 31 votes on the same legislation (reftel), with ostensibly pro-presidential MPs failing to support the measures. It is unclear whether Yushchenko could not, or chose not, to deliver the votes of MPs still considered loyal to him.

¶3. (C) Afterwards PM Tymoshenko convened an extraordinary meeting of the CabMin, which quickly adopted 19 resolutions that aim to achieve the same fiscal results foreseen in the legislation. In a subsequent meeting with the Ambassador, Tymoshenko said that all CabMin members, including those ministers with close ties to President Yushchenko, supported the measures with little debate. Tymoshenko told the Ambassador that IMF Mission director Ceyla Pazarbasioglu participated in the CabMin meeting and subsequently approved the measures. According to Tymoshenko, the actions will

allow Pazarbasioglu to recommend to the IMF Board that the overdue, \$1.87 billion second tranche of the Stand-By Arrangement be disbursed to Ukraine.

IMF Accepts Resolutions in Lieu of Laws

14. (C) The local media quoted Pazarbasioglu as saying that Ukraine had now done all it could under the present circumstances. The IMF would now discuss the individual resolutions with the GOU in greater detail in the coming days. IMF resident rep Max Alier confirmed to us on April 15 that the IMF had not yet studied the resolutions in detail, but looked prepared to accept the results. "Of course having the measures approved by the Rada would have been more kosher," Alier told us, "but if the Rada is not game then we will have to live with the resolutions." Earlier, he told us point blank that the IMF Mission team could not back out of Ukraine a second time without disbursing the second tranche. He said the IMF made a calculated decision that the GOU would not get budget legislation passed, and decided to accept that the GOU can tackle the fiscal deficit via resolutions.

15. (C) It now appears clear that the Tymoshenko government had prepared the resolutions long in advance of the April 14 meeting. Tymoshenko and Deputy PM Nemyrya showed the Ambassador the voluminous stack of resolutions and supporting documentation, all of which would have required significant planning in Ukraine's slow bureaucracy. The IMF was aware of this fallback plan when the Mission returned to Ukraine last week, with Pazarbasioglu telling the Ambassador on April 11 that she was impressed at the GOU's preparations of a

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comprehensive "Plan B" for the event that the Rada vote failed. At that time she had already indicated that the IMF would be open to accepting resolutions in lieu of laws if they achieved similar fiscal results. She said the measures would leave a forecast budget deficit of roughly 4 percent of GDP, which at current exchange rates equals roughly \$4 billion.

Bank Recap Group to Designate 6-8 Banks

16. (C) Tymoshenko also told the Ambassador that she would chair the first meeting of the newly created GOU board dealing with bank recapitalizations on April 15. At the meeting, which both IMF and World Bank will attend as observers, the GOU would announce the first group of banks that will receive recapitalization funds from the government. Separately, Nemyrya had told the Ambassador that the board would announce a group of six to eight banks that had been identified using objective criteria. The results of the stress tests conducted by the NBU earlier this year would play a major role, as well as whether the bank was deemed systemic (barometer would be the relative size of its deposit base) and whether the bank was already under temporary NBU administration, Nemyrya said.

Second Tranche in the Form of Budget Support?

17. (C) Tymoshenko said the GOU was asking the IMF to pay out the \$1.87 million tranche directly to the state budget, as the situation on the foreign exchange market had stabilized while the overall fiscal situation was deteriorating by the day. She also said the GOU hoped to combine the disbursement of the second and third tranches, which was originally scheduled to be disbursed on May 15, and should total about \$3.6 billion, or double the amount of the second tranche. Later on April 14 IMF resident rep Alier told us that a payment directly to the budget was possible, and even likely. Combining the tranches, however, was "a pie in the sky," he said. In her discussion with the Ambassador, Tymoshenko had acknowledged that the IMF had said combining the tranches

would significantly delay their joint disbursement, possibly to the end of May. She asked the Ambassador that the USG weigh in with the IMF to accelerate a joint disbursement, as the political situation in Ukraine was making it increasingly difficult to get anything done, and that the budget desperately needed the funds.

Can Resolutions Work in Lieu of Laws?

¶8. (C) Cabinet of Ministers decrees are commonly used policy tools in Ukraine's volatile political environment. We have observed that the current GOU has resorted to resolutions on trade-related issues when the Rada has either passed legislation that violates Ukraine's international obligations, or failed to support international commitments that the GOU has promised. However, under Ukrainian law cabinet resolutions are generally used for setting the procedures to implement laws. They cannot contradict laws or presidential decrees, and they are generally far easier to reverse than acts of law.

¶9. (C) It remains to be seen whether the resolutions adopted on April 14 will provide a sustainable policy environment in the mid- to longer term. Cabinet of Ministers resolutions do not carry the same status as laws passed by the Rada or presidential decrees, and they are vulnerable to challenges from both the President and from parliamentarians. President Yushchenko can issue a decree suspending CabMin resolutions while he challenges them in court. In addition, a group of at least 45 Rada MPs can challenge the legality of CabMin resolutions in court, during which time the resolutions are automatically suspended.

¶10. (C) As yet, however, Yushchenko has not indicated that he will contest the CabMin's actions. On April 15 he called the GOU approach "exceptionally positive" but said the results were not ideal from an economic point of view. He said that the Presidential Secretariat would investigate the legal, economic and political implications of the resolutions. Separately, he had indicated that the price hikes for energy could cause an increase in inflation. In the Rada, pro-presidential Our Ukraine-People's Self Defense deputy Vjacheslav Kyrylenko called the resolution hiking

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pension contributions illegal, arguing that the payments are akin to tax payments and hence fall under the purview of the Rada. He did not indicate a willingness to formally challenge the measures, however.

"Inconsistencies" Opened Path for Some Resolutions

¶11. (C) Nemyrya told the Ambassador that the GOU "used inconsistencies in the law" when drafting the resolutions. The Ministry of Justice, led by Yushchenko supporter Onyshchuk, had reviewed the measures and deemed them to be in accordance with the law, he said. For example, one resolution will increase the monthly amount that small and medium enterprises (SMEs) pay to the pension fund from 80 UAH (\$10) to 208 UAH (\$26) per month, a measure that should increase revenue by 1.9 billion UAH (\$237 million) for the remaining eight months of 2009, Nemyrya said. SMEs have enjoyed lower pension payments since former President Kuchma issued a corresponding decree in 1998, he said. Hence the CabMin was confident it could change the decree by passing a resolution. Nemyrya said he expects Yushchenko's supporters to attack the measures, but expressed confidence that the GOU could defend its actions because the pension privileges that SMEs enjoyed put other groups with higher pension fund contributions, such as teachers, at a disadvantage and actually forced them to subsidize the pensions of small entrepreneurs.

12. (C) Two other resolutions aim at improving the financial

situation at Naftohaz. One resolution makes a "recommendation" to the independent tariff regulator to introduce higher, sliding scale gas and electricity prices for retail households that consume large amounts of energy. Another resolution introduces a 2 percent surcharge on the price of natural gas delivered to some industrial users, a measure that Energy Minister Prodan said would boost revenues by UAH 560-580 million (about \$70 million.)

¶13. (C) The resolutions pertaining to pensions appear to contain measures nearly identical to the measures foreseen in the failed pension reform draft. As yet it is unclear, however, whether the energy-related resolutions will help fully plug the holes in Naftohaz's finances. The failed legislation had foreseen measures to compensate a UAH 6.1 billion (\$762 million) deficit at Naftohaz which will arise because the company sells gas domestically at administratively set prices far below what it pays for gas imports from Russia.

Comment

¶14. (C) The IMF understands the vagaries of Ukrainian politics, and it is now clear that it would not make its decision to disburse the next tranche dependent on the outcome of the April 14 Rada vote. It and the GOU are walking a thin line with this approach, but in Ukraine's volatile political environment this is the quickest option as long as President Yushchenko is unwilling or unable to convince his remaining supporters to support crisis-related legislation. The IMF recognizes that Ukraine's fiscal situation is deteriorating rapidly -- in the first three months of this year, a time when the budget normally has a seasonally induced surplus, the budget deficit was 1.5 percent of GDP. Hence action is needed. With no other sources of budget support on the horizon, the IMF realizes that taking the (unrealistic) high road won't help Ukraine in the short- to medium-term, and would actually work against what the Fund is trying to achieve in Ukraine. The resolutions are still open to challenge by the President, or Rada deputies. However fragile and institutionally questionable, the resolutions are the quickest option that the GOU had to meet IMF expectations. End comment.

TAYLOR